

Internal Revenue Service
memorandum

TL-N-6896-88

CC:TL:TS/WHEARD

date: **SEP - 9 1988**

to: Director, Office of Coordinated Examinations EX:C

from: Director, Tax Litigation Division CC:TL

subject: TEFRA Questions/Treatment of Basis in a Partnership Interest

This memorandum is in response to your request for technical advice dated June 13, 1988, regarding the treatment of a partner's basis in his partnership interest.

ISSUES

1. When is an adjustment to a partner's basis in his partnership interest a partnership item, an affected item, or a non-partnership item?
2. What statute of limitations applies to affected item basis adjustments?

CONCLUSION

1. If the determinations which make up the basis of a partner in his partnership interest are comprised solely of partnership items (e.g., the amount the partner contributed to the partnership and his allocable share of income, deductions, and credits) his basis is a partnership item, the tax consequences of which are assessable as a computational adjustment following a determination of its partnership components at the partnership level.

If additional or substitute determinations at the partner level must also be made (e.g., the amount a partner bought his partnership interest for from the original contributing partner when an I.R.C. § 754 election is not in effect), then the partner's basis is an affected item for which an affected item notice of deficiency must be issued under section 6230(a)(2)(A)(i) following the determination of its partnership item components in a partnership proceeding.

Only if a partner's partnership items convert to nonpartnership items under section 6231(b) would the determination of basis be a nonpartnership item.

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2. Section 6229(a), in addition to providing the period for assessment for partnership items, provides the period for assessing affected items.

DISCUSSION

I. Partner's Basis in Partnership Interest

Generally a partner's basis in his partnership interest is a partnership item or an affected item, depending upon whether his basis is comprised solely of partnership items or not.

Section 6231(a)(3) provides that a "partnership item" is:

any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level.

Section 6231(a)(5) provides that:

The term "affected item" means any item to the extent such item is affected by a partnership item.

If a partner's basis in his partnership interest is comprised solely of partnership items as defined by Treas. Reg. § 301.6231(a)(3), then the partner's basis is also a partnership item. A partner's basis in his partnership interest is generally determined by: the initial contribution to the partnership (including the partner's share of recourse liabilities incurred by the partnership); all subsequent contributions by the partner to the partnership; distributions from the partnership; the partner's share of taxable income, nontaxable income and the losses and deductions of the partnership, up to the date as of which the partner's basis is to be determined. See section 705(a) and (b). These are all partnership items under the above regulation. A basis determination reflecting solely partnership items is reflected in the partner's capital account.

If an additional or substitute determination is required which is not a partnership item, such as the amount a new partner pays to purchase a partnership interest from an pre-existing

partner when no election under section 754 is in effect,^{1/} then the partner's basis is an "affected item." In this situation, the initial basis of the new partner will comprise of his purchase price (a nonpartnership item) rather than comprise of an initial contribution to the partnership (a partnership item). Notwithstanding that the purchase price is not partnership item in the absence of a section 754 election, it will be affected (increased or decreased) by a partner's allocable share of partnership items. It is, thus, an affected item. See Temp. Treas. Reg. § 301.6231(a)(5)-1T(b).

At risk determinations are treated similarly. For example, a partner's amount at risk would require a partnership level determination when a partnership, engaged in an activity subject to section 465, had borrowed an amount for use in that activity. The partner's share of the partnership liability for purposes of section 465 requires a partnership level determination. Therefore, that portion of the partner's amount at risk is a partnership item.

On the other hand, when a partner borrows money to purchase a partnership interest in the partnership engaged in an activity subject to section 465, the character and amounts of the borrowing for purpose of section 465 requires a partner level determination. The portion of the partner's amount at risk attributable to that borrowing is an affected item. Temp. Treas. Reg. § 301.6231(a)(5)-1T(c).

II. Assessment and Statute of Limitations For Affected Items

Assessment of Affected Items

Changes to the partnership item components of a partner's basis can only be made through a proceeding at the partnership level. If all components of a partner's basis are partnership items, basis will be calculated as a computational adjustment following the proceeding and directly assessed. If there are additional components to a partner's basis which are not partnership items, then the partner's basis in his partnership interest is an affected item.

Affected items can be assessed two different ways depending upon what determinations are required.

^{1/} Such an election operates to make a purchasing partner's capital account equal to the purchase price. This has the effect of converting his partner level determination (i.e., the purchase price) to a partnership item.

Section 6230(a)(2)(A)(i) provides for a statutory notice of deficiency to be issued for affected items which require partner level determinations. These affected items do not simply flow through to the partner's return since some additional partner level determination must be made which is not apparent from the partnership return. For example, where a partner purchased his interest in the partnership from an founding partner and the partnership has not made a section 754 election the purchase price is not determinable at the partnership level. The determination is, thus, subject to a deficiency procedure following the partnership proceeding. Similarly, when a partner has borrowed money to purchase a partnership interest, the character and amount of the borrowing for at risk purposes is an affected item subject to deficiency procedures. These procedures are available following the TEFRA proceeding.

On the other hand, assessment of tax attributable to affected items that do not require partner level determinations can be done through a computational adjustment (along with tax attributable to partnership items). I.R.C. § 6230(a)(1). For example, the threshold for a medical deduction is a percentage of adjusted gross income. A change in partnership income or loss (a partnership item) will change the threshold for the partner's medical deduction (medical deduction = expense - threshold amount). This is merely a mathematical adjustment. It does not challenge the validity of the medical expense itself. The resulting change in the partner's medical deduction is an affected item that does not require a partner level determination. A computational adjustment should then be made.

Statute of Limitation for Affected Items

The period of assessment for affected items is controlled by section 6229(a). Section 6229(a) provides:

Except as otherwise provided in this section, the period for assessing any tax imposed by subtitle A with respect to any person which is attributable to any partnership item (or affected item) for a partnership taxable year shall not expire before the date which is 3 years after the later of-

- (1) the date on which the partnership return for such taxable year was filed, or
 - (2) the last day for filing such return for such year (determined without regard to extensions).
- (emphasis supplied)

Affected items cannot be assessed prior to the completion of a partnership level proceeding. N.C.F. Energy Partners v. Commissioner, 89 T.C. 741 (1987). Following a partnership proceeding (when the FPAA expires without a petition being filed or a final decision of a court is entered) section 6229(d)(2) suspends the period for assessment under section 6229(a) for one year. Thus, the Service has one year following a partnership proceeding to issue an affected item notice of deficiency for basis adjustments which are affected items requiring partner level determinations or, if the basis determination is solely a partnership item or an affected item requiring only a mathematical computation, we have one year to assess through a computational adjustment.

III. HYPOTHETICALS

You provided hypothetical situations for illustration purposes (see attached).

In the first hypothetical you ask how a basis adjustment should be raised in a 60 day letter. A basis adjustment as such does not need to be raised. Rather, you should raise as issues the partnership item components of basis which you wish to adjust and the allocation of these items to partners (if this is an issue). Following the TEFRA proceeding basis will be calculated as a computational adjustment based on partnership determinations.

The second and third hypotheticals ask how can the Service assess tax attributable to an affected item basis adjustment requiring partner level determinations when a partnership proceeding is not instituted or an NBAP is withdrawn. Although an affected item notice of deficiency cannot be issued until after a TEFRA proceeding is complete (see N.C.F. Energy Partners, Ltd. v. Commissioner, supra), it is our position that, where no TEFRA proceeding is initiated or contemplated or an NBAP is withdrawn, the Service may issue an affected item notice of deficiency solely with respect to the partner level determinations necessary to compute basis. In this scenario the partnership item components of basis reported on the partnership return must be accepted as reported and only partner level determinations, such as the amount a partner paid for his partnership interest when no section 754 election is in effect, can be adjusted in the affected item notice of deficiency. The affected item notice of deficiency must be issued within the period provided for in section 6229(a), normally three years from the time the partnership return is required to be filed or is filed, whichever is later.

With respect to hypothetical four, to the extent basis is comprised solely of partnership items it is a partnership item. To the extent there are additional factors not determinable at the partnership level which affect basis, basis is an affected item. The partnership item components can only be adjusted at the partnership level. Partner level determinations which are not merely mathematical determinations can be made through an affected item notice of deficiency following the TEFRA proceeding. As noted above, if no TEFRA proceeding is initiated or contemplated the partner level adjustments can be made through an affected item notice of deficiency, but the partnership item components of basis must be accepted as reported on the partnership return.

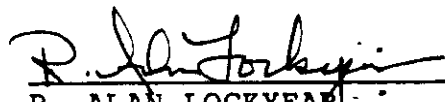
With respect to hypothetical five (how an affected item is assessed), if a partner's basis is comprised solely of partnership items, it is subject to a computational adjustment. If additional or substitute determinations are required which cannot be determined at the partnership level, then an affected item notice of deficiency will need to be issued. See discussion on pages 3 and 4 of this memorandum.

The last hypothetical raises the issue of partners taking deductions in excess of their basis as reported on the partnership return. Under TEFRA, partners are required to file consistently with the information contained on a partnership return. I.R.C. § 6222. To the extent they file 1040s inconsistently with the partnership return, the Service can make a computational adjustment to conform their personal returns to the partnership return (unless the partner files a notice of inconsistent filing). Because the partners did not file consistently with the partnership return (by taking deductions in excess of reported basis) the Service can conform their personal returns to the partnership return through a computational adjustment disallowing deductions in excess of basis. No TEFRA proceeding need be initiated.

Please refer any questions regarding this advice to Bill Heard at FTS 566-3289.

MARLENE GROSS

By:


R. ALAN LOCKYEAR
Senior Technician Reviewer
Tax Shelter Branch

Attachments:
As stated.

Dennis Beach
Midwest Region

Situation 1:

A partner's basis in his partnership interest is determined to be a partnership item at the partnership level. What would be the appropriate language and format for the 60-day letter and Final Partnership Administrative Adjustment letter?

Situation 2:

A partner's basis in his partnership interest is originally determined to be an affected and the partnership is still under examination. In the attached opinion, Chicago District Counsel, advised Chicago Quality Review staff to suspense the case until conclusion of the partnership examination. If the partnership examination determines the basis adjustment to be a partnership item we would proceed as in Situation 1. What if this issue was correctly treated as in affected item, how should the suspense unit be notified that there is an adjustment subject to the normal deficiency procedures? Is the audit of the partnership considered to be a no change when the only items adjusted are affected items? If it is a no change, what is the statute date for making the adjustment to the partners?

The statute is clearly defined if a Final Partnership Administrative Adjustment letter is issued, since the one year assessment date will control the statute of the partner. The problem will only arise when the audit is completed in the forty-five day period, when the Notice of Beginning of an Administrative Proceeding letter may still be withdrawn. (Temporary Regulation §301.6223(a)-2T)

Situation 3:

A partner's basis adjustment to his partnership interest is determined to be an affected item at the partner level, but the partnership is not under audit. Per counsel's opinion the controlling statute is that of the partnership. Should the partners statute be updated to that of the partnership? If not, what procedures should be utilized to adequately insure that the basis adjustment is made before the statute expires?

Situation 4:

When is an adjustment to a partner's basis an affected item versus a partnership item if all information is available from both the partnership and the partner? Are we required to first look to the partnership for this determination and thus start an administrative proceeding?

Situation 5:

Under what circumstances would the adjustment to a partner's basis as an affected item is considered a computational adjustment under IRC 6231(a)(1) and Temporary Regulations §301.6231(a)(6)-1T?

Situation 6:

A partnership has been in existence for several years, which may or may not have been examined. Each year the partners have claimed the flow through losses

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which appear to be in excess of their basis. The partner's capital accounts are a negative amount at year end. The partnership may or may not have filed a final return, they appear to be walking away from the investment and never filing any subsequent returns. Must a partnership proceeding be initiated in order to make the possible burn-out income adjustments to the partners?

A copy of the various District Counsels' advisory opinions are included for your information. When the TEFRA tax law initially came into being, it was not felt that it prevented the disallowance of a partner's loss due to no remaining basis either before the partnership proceeding was completed or even before a partnership proceeding was initiated. The current opinions seem to be saying that a partnership proceeding must be initiated before a basis adjustment may be made. Any guidance National Office can provide to clarify the proper procedures and handling of adjustments due to basis limitations as set forth in the above situations will be beneficial.

If you have any questions on this information, a member of your staff may contact Nancy Jones, Chief, Examination Support Section at FTS 757-3337.


Nancy Jones

Attachments